CONTINUITY OF INTEREST IN REORGANIZATION UNDER THE FEDERAL INCOME TAX

THE reorganization and exchange provisions of the Federal Revenue Acts were passed in pursuance of a policy to expedite corporate consolidation and merger, and the alteration of capital structure.[1] They are a statutory exception to the principle that when parties engage in an exchange of properties and the properties received by either party are of greater value at the date of the exchange than the cost of the properties transferred, income in the constitutional sense is realized if the form of the original investment is changed.[2] They recognize, in fact, that many such transactions do not produce a severance in any practical sense from the original capital investment, but, though a different form of properties may be held, still keep such properties subject to the risks of the original enterprise. The Revenue Act,[3] therefore, postpones recognition of the income realized from such exchanges for tax purposes until a subsequent sale of the properties does produce a practical severance from the enterprise in which the investment was held prior to the exchange.[4]

The Revenue Acts, since 1924,[5] have contained articulate provisions describing the transactions which are deemed to fall within the policy of postponing the tax.[6] These constitute various types of exchange;[7] two of these types require, for the postponement of tax, the presence of a reorganization.[8] The statute defines explicitly what transactions shall constitute a reorganization.[9]

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1. See SEN. REP. No. 275, 67th Cong., 1st Sess. (1924); H. R. REP. No. 350, 67th Cong., 1st Sess. (1924).

2. United States v. Phellis, 257 U. S. 156 (1921); Rockefeller v. United States, 257 U. S. 176 (1921); Cullinan v. Walker, 262 U. S. 134 (1923); Marr v. United States, 268 U. S. 536 (1925).

3. INT. REV. CODE § 112(a)-(j) (1939).

4. For a general discussion of the history and effect of these provisions, see BAAR AND MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS (1935); Fahey, *Income Tax Definition of Reorganization* (1939) 39 COL. L. REV. 933.

5. Such provisions appeared first in the 1918 and 1921 Acts in simplified form. Revenue Act of 1918, § 202(b); Revenue Act of 1921, § 202(c).

6. Revenue Acts of 1924 and 1926, § 203; Revenue Acts of 1928, 1932, 1934, 1936 and 1938, § 112; INT. REV. CODE § 112 (1939).

7. In the 1924 and 1926 Revenue Acts, § 203(b)(1)-(b)(4); in later Acts, § 112(b)(1)-(b)(5).

8. "§ 112(b)(3). No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

"§ 112(b)(4). No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

9. The definition as it existed from 1924 to 1934, with which this Comment is to be primarily concerned, reads: "The term 'reorganization' means (A) a merger or con-

Transactions which may be reorganizations in other fields of law or business, but which do not fall within the statutory definition, do not aid in determining whether a postponement of recognition of gain or loss should be made. Even if a transaction does fall within the statutory definition of a reorganization, such a transaction does not itself give rise to nonrecognition, but serves as a condition precedent to the two types of exchanges, themselves specifically described in the statute, which do effect a postponement of the tax. The policy of requiring a maintenance of the original investment is articulated in these exchange provisions by the requirement that the properties received in the exchange be "stock or securities." The statutory definition of reorganization, as it existed prior to 1934, required a transfer by a corporation of a majority of its stock or of substantially all its assets, but made no provision as to the consideration which was to be received from the transferee.

The literal terms of the definition of a Part (A) reorganization, therefore, would be satisfied even if the consideration received was cash. Some judicial restriction was therefore necessary to prevent an application of the definition which would defeat the statutory policy of exempting from the recognition of gain or loss transactions in which there had been no practical severance from the business enterprise. This restriction was provided by the rule of "continuity of interest." Under Part (A) of the definition of reorganization, something at least in the nature of a merger or consolidation is required, and the essence of such a transaction is a retention by the transferor of a continuing interest in the transferee. Thus though Part (A) is silent as to consideration, it is construed to require a receipt of a consideration representing a continuity of interest.[10] This Comment presents an analysis of the rule of continuity of interest as applied by the courts to the Revenue Acts in effect from 1924 to 1934. The Acts since 1934, by redefining the term "reorganization,"[11] have restricted the application of the rule. In the light of the tardiness of tax litigation, however, the earlier Acts will for several years be subject to judicial interpretation;[12] and, in addition, for reasons

solidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form or place of organization, however effected." Revenue Acts of 1924 and 1926, § 203(h)(1); Revenue Acts of 1928 and 1932, § 112(i)(1).

10. Le Tulle v. Scofield, 60 Sup. Ct. 313 (U. S. 1939); Groman v. Comm'r, 302 U. S. 82 (1937); Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U. S. 462 (1933); Cortland Specialty Co. v. Comm'r, 60 F. (2d) 937 (C. C. A. 2d, 1932), *cert. denied*, 288 U. S. 599 (1933).

11. Revenue Acts of 1934, 1936, and 1938, § 112(g)(1); INT. REV. CODE § 112(g)(1) (1939).

12. The latest decision in the Supreme Court, decided in January, 1940, arose under the 1928 Act. LeTulle v. Scofield, 60 Sup. Ct. 313 (U. S. 1940).

to be indicated,[13] the concept of continuity will continue to be a factor in the administration of the more recent Acts.

This concept first appeared in *Cortland Specialty Company v. Commissioner*,[14] and in *Pinellas Ice and Cold Storage Company v. Commissioner*.[15] In the *Pinellas* case, a company under a contract phrased in the language of a sale transferred all its assets to another corporation in return for $400,000 in cash and $1,000,000 in notes of the transferee payable within a year. The Commissioner of Internal Revenue contended that the transaction was a sale, and, therefore, not within the Revenue Act. The taxpayer contended that the transaction was within the literal terms of the statute, as all the assets had been transferred, thereby effecting a reorganization under Part (A) of the definition, in return for a receipt of securities (notes) of the transferee. The Board of Tax Appeals did not direct its argument to the definition of reorganization, but held that the term "securities" in the exchange provisions was limited by the general purposes of the legislation to exclude a consideration so like cash as short term notes.[16] The circuit court of appeals held there was no merger or consolidation within the statutory requirements.[17] The Supreme Court stated that the definition was not limited to actual mergers or consolidations, as that would nullify the effect of the parenthetical clause. The Court held, however, that a transaction, to be within the statute, must result in an "interest in the affairs of the purchasing company more definite than that incident to ownership of its short term purchase money notes."[18]

In the *Cortland* case, there was also a transfer of substantially all the assets in exchange for short term notes. Emphasis was again placed on the concept of merger or consolidation, which, it was held, "presupposed a continuance of interest on the part of the transferor in the properties transferred."[19] As a further ground of decision, it was held that the notes were not "securities" within the exchange provisions because they were too similar to cash.

The *Cortland* and *Pinellas* cases established the proposition that the consideration received by the transferor must not be too similar to cash, but did not profess to define affirmatively the nature of the consideration which would satisfy the rule of continuity. In *Helvering v. Minnesota Tea Company*,[20] the Supreme Court began the process of establishing more specific standards for the application of the rule. In that case, the consideration received was 44 per cent cash and the balance in voting stock. The Revenue Act itself seems to recognize, in the boot provisions, that in order to have a non-taxable exchange it is not necessary that the entire consideration meet

13. See p. 1089 *infra*.

14. 60 F. (2d) 937 (C. C. A. 2d, 1932), *cert. denied*, 288 U. S. 599 (1933).

15. 287 U. S. 462 (1933).

16. Pinellas Ice & Cold Storage Co., 21 B. T. A. 425 (1930).

17. Pinellas Ice & Cold Storage Co. v. Comm'r, 57 F. (2d) 188 (C. C. A. 5th, 1932).

18. Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U. S. 462, 470 (1933).

19. Cortland Specialty Co. v. Comm'r, 60 F. (2d) 937, 940 (C. C. A. 2d, 1932).

20. 296 U. S. 378 (1935).

the requirements of continuity of interest. In accordance with the implication raised by these provisions, the Supreme Court held that the rule was satisfied so long as a continuing interest was acquired which represented a material part of the value of the assets transferred.[21] It was held further that, under Part (A) of the definition, control of the transferee was not required; that the relationship of the transferor to the assets could be substantially altered; and that dissolution of the transferor company was not necessary. In *Nelson v. Helvering,* decided the same day, the Court held a voting interest unnecessary, by ruling that preferred stock met the requirements of continuity.[22]

The *Minnesota Tea* and *Nelson* cases, while providing some affirmative indication of the nature of the rule, did not profess to define the quality of the interest which was required. In both cases the consideration received was stock giving a proprietary or equity interest. It was nowhere stated in these cases, however, that such an interest was necessary. In the *Pinellas* and *Cortland* cases, a creditor's interest had been rejected; but those holdings turned, not on the absence of an equity interest, but on the fact that the short term nature of the notes rendered them too similar to cash. Further, the *Cortland* case had discussed the rule in terms of an interest in the assets transferred rather than a proprietary interest in the business affairs of the transferee corporation.[23] In dealing with bonds, not subject to the shortcomings of the notes in the *Cortland* and *Pinellas* cases, it became important to decide which of these two types of interest would be required for purposes of the continuity rule. Bonds, as creditor's rights, provide an even greater link than stocks with the transferee's assets, especially if the bonds are secured by a mortgage on the properties transferred. If, therefore, continuity of interest meant an interest in assets, bonds would fulfill the requirement, but if the rule required a proprietorship interest, stock would be required.

The issue as to long term bonds first came before the Supreme Court in *Helvering v. Watts.*[24] Here the consideration was 50 per cent stock and the balance in bonds. Since a material part of the consideration was in stock,

21. There has been as yet no authoritative determination as to what percentage of the total consideration received must represent a continuing interest in order to satisfy this requirement of a "material part." In Helvering v. Minnesota Tea Co., 296 U. S. 378 (1935), 44% was sufficient. In Miller v. Comm'r, 84 F. (2d) 415 (C. C. A. 6th, 1936), 50% of the consideration represented continuity, but the court stated that anything other than a nominal interest would suffice. In the same circuit, however, in Banner Machine Co. v. Routzahn, 107 F. (2d) 147 (C. C. A. 6th, 1939) a proportion of 20% was held insufficient. The main grounds for the decision was that the transaction was intended as a sale of which the receipt of a preponderate proportion of cash was evidence.

22. 296 U. S. 374 (1935).

23. 60 F. (2d) 937 (C. C. A. 2d, 1932). The court states: "Each transaction presupposed a continuance of interest on the part of the transferor in the properties transferred." *Id.* at 940.

24. 296 U. S. 387 (1935).

under the authority of the *Minnesota Tea* case a reorganization had been effected, apart from the question of whether bonds provided continuity for purposes of the definition. But since under the boot provisions gain would be recognized to the extent of a receipt of property other than stock or securities,[25] it was material to determine whether the long term bonds were "securities." The Supreme Court held that they were, since they were free from the defects of the notes in the *Pinellas* case. Consequently the whole gain was exempt from tax. But since by reason of the receipt of stock, a reorganization already existed, the *Watts* case did not decide that bonds alone satisfied the rule of continuity as applied to the definition.

Because of the lack of such an authoritative determination, the lower courts and the Board of Tax Appeals reached diverse results in their treatment of bonds. The most common ground of decision was the long or short term nature of the bonds, and it was held in several cases that long term bonds, unlike short term bonds, represented an investment which provided a continuity of interest.[26] Another factor considered by the courts was the presence or absence of security for the bonds, one case holding that a lack of security implied a greater interest in the business affairs of the transferee,[27] and the other that mortgage bonds provided a more than satisfactory continuity in the assets transferred.[28] The affinity between the concept of continuity as applied to "securities" and as applied to the definition of reorganization was

25. Revenue Act of 1924, § 203(d)(1). The provision reads: "If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

26. L. & E. Stirn, Inc. v. Comm'r, 107 F. (2d) 390 (C. C. A. 2d, 1939) (bonds received pursuant to a recapitalization held too short in term); Comm'r v. Tyng, 106 F. (2d) 55 (C. C. A. 2d, 1939), *rev'd*, 60 Sup. Ct. 378 (U. S. 1940); Comm'r v. Freund, 98 F. (2d) 201 (C. C. A. 3d, 1938) (bonds maturing in series in from one to six years held sufficient); Burnham v. Comm'r, 86 F. (2d) 776 (C. C. A. 7th, 1936), *cert. denied*, 300 U. S. 683 (1936) (long term notes held to provide continuity for purposes of the term "securities"). Long term bonds were also held to provide continuity by the Board of Tax Appeals in Kaspare Cohn, Ltd., 35 B. T. A. 646 (1937); Lelia S. Kirby, 35 B. T. A. 578 (1937); Karl B. Segall, 38 B. T. A. 43 (1938).

Long term bonds were held insufficient evidences of continuity in Averill v. Comm'r, 101 F. (2d) 644 (C. C. A. 1st, 1938); Speedway Water Co. v. United States, 100 F. (2d) 636 (C. C. A. 7th, 1938); Worcester Salt Co. v. Comm'r, 75 F. (2d) 251 (C. C. A. 2d, 1935); George D. Graham, 37 B. T. A. 623 (1938) (result reached primarily by reference to the intent of the parties as to the nature of the transaction); Frank M. McNab, 33 B. T. A. 192 (1935); Hay Foundry & Iron Works, 33 B. T. A. 144 (1935).

27. Comm'r v. Tyng, 106 F. (2d) 55 (C. C. A. 2d, 1939), *rev'd*, 60 Sup. Ct. 378 (U. S. 1940).

28. Scofield v. Le Tulle, 103 F. (2d) 20 (C. C. A. 5th, 1939), *rev'd*, 60 Sup. Ct. 313 (U. S. 1940).

recognized by holdings to the effect that bonds satisfied the continuity requirement *because* they were "securities."[29]

The holdings in these last cases were persuasive. If bonds satisfied the continuity requirement for purposes of the exchange and boot provisions,[30] as in the *Watts* case, it seems logical that they would also satisfy it for purposes of the definition.[31] In both connections the requirement seems intended to effectuate the same underlying policy considerations of preventing nonrecognition of gains resulting from transactions which are basically sales. When, however, the issue was squarely presented to the Supreme Court in *LeTulle v. Scofield,* in which bonds alone formed the consideration for the exchange, the implication of the *Watts* case was ignored. The Court also deemed irrelevant the long or short term, and the secured or unsecured nature of the bonds. It decided that the sole question was whether or not a *proprietorship interest in the enterprise* was obtained, and held that bonds did not provide such an interest.[32]

Of course, except for the logical inconsistency of its holding with the implication of the *Watts* case, the Court in the *LeTulle* case was free to formulate whatever positive standard of continuity it chose, since the earlier cases had left open the question of the nature of the interest required. The result of the case, however, is that there now exist, in effect, two rules of continuity — one limiting the term "securities" in the exchange provisions; the other, limiting the definition of reorganization in Part (A). This separation of the concept into two rules, while perhaps not wholly logical in terms of the reasoning of the *Watts* case, is proper as a matter of tax policy. The Court was free to assure a retention of continuity under the definition by requiring a receipt of some stock; indeed, as to a Part (B) reorganization, since 1934, the Acts require that the consideration be solely in voting stock.[33] But there is no reason why, if the minimal requirements of stocks for purposes of the definition are met, the holding of the *Watts* case that bonds are securities for purposes of the exchange provisions should not also be applied so as to exempt from any recognition of gain or loss a consideration part in stock and the balance in bonds. In the light of the affinity of the two rules, however, there is a danger that the lower courts will impose on the term "securities" the same requirement of a proprietary interest which the *LeTulle* case has applied to the definition of a reorganization. But the fact that the exchange provisions include "stocks *or* securities" seems a strong argument for maintaining the rule in its present double form.

29. Comm'r v. Tyng, 106 F. (2d) 55 (C. C. A. 2d, 1939), *rev'd,* 60 Sup. Ct. 378 (U. S. 1940); White v. United States, 22 F. Supp. 821 (Ct. Cl. 1938).

30. See notes 8 and 25 *supra.*

31. See note 9 *supra.*

32. LeTulle v. Scofield, 60 Sup. Ct. 313 (U. S. 1940).

33. INT. REV. CODE § 112(g) (1) (1939); Revenue Acts of 1934, 1936 and 1938, § 112(g) (1).

While the holding in the *LeTulle* case rests on a concept of a proprietary interest and a stake in the business affairs of the transferee, another class of case, raising the issue of continuity of interest, has emphasized interest in the actual assets transferred. This has been the approach in dealing with the question of whether stock of a parent company, received in exchange for the transfer of assets to a subsidiary, provides the transferor with a continuing interest in the subsidiary. Practical circumstances frequently give rise to such a situation. Where the parent company is a holding company desiring to acquire operating properties, not only will it not be feasible to include such properties within its own corporate structure, but the parent will in many cases not wish to jeopardize its control of its subsidiary by returning stock of the subsidiary in exchange for the assets received.[34]

The issue as to whether stock of a parent satisfied the rule of a continuing interest was first raised in the famous case of *Groman v. Commissioner*.[35] Here all the stock of an Indiana corporation was transferred to an Ohio corporation, itself a subsidiary of Glidden corporation. The shareholders in Indiana received in exchange cash and preferred stock of both Ohio, the subsidiary, and Glidden, the parent. The Commissioner claimed that the shares of Glidden were not stock of a party to the reorganization effectuated between Indiana and Ohio[36] as was required by the applicable exchange provision.[37] It was alleged that Glidden was not a party because it did not itself receive the assets, and its stock did not represent a continuing interest in the assets.[38] The Supreme Court supported this contention, holding that there was lacking under the definition a receipt of the conveyed properties by Glidden, and a return by Glidden of a consideration bearing a continuing interest in such properties. To the argument of the taxpayer that the parent-subsidiary relationship between the two corporations gave the stock of the parent all the attributes of continuity, the Court replied that it would not disregard the corporate entity.

34. For a good example of practical circumstances necessitating the receipt of the assets by the subsidiary, see Samuel A. Neidich, 38 B. T. A. 1178 (1938).

35. 302 U. S. 82 (1937).

36. There was a reorganization between Indiana and Ohio under Part (A) of the definition by reason of an acquisition by Ohio of all the stock of Indiana for which it returned to the shareholders of Indiana its own preferred stock. See definition of reorganization in note 9 *supra*.

37. Revenue Act of 1928, § 112(b) (3). See note 8 *supra*.

38. The term "party" was defined in § 112(i) (2) of the Revenue Act of 1928 under which the *Groman* case arose. This definition does not purport to be exclusive, as under it, the term "party" only *"includes"* the attributes defined in the statute. By § 701(b) of the same Act, the use of the term "includes" expressly renders the definition non-exclusive. It was necessary, therefore, to determine whether Glidden was a "party" within the ordinary meaning of the term. The lower court erroneously construed the definition of "party" as being exclusive in Comm'r v. Groman, 86 F. (2d) 670 (C. C. A. 7th, 1937). "Party" is still a non-exclusive definition. INT. REV. CODE §§ 112(g) (2), 3797(b) (1939); Revenue Act of 1938, §§ 112(g) (2), 901(b).

If stock of a "party" to a reorganization must be stock bearing a continuing interest in the assets transferred,[39] the conclusion of the Court that such interest was not here present seems unsatisfactory. The Court appears to have reached this conclusion by reasoning that because the stock of the subsidiary did represent continuity, the stock of the parent did not, since the parent was a different corporation holding different assets.

The Court's opinion seems confusing and highly technical. Yet the problem in the light of the purpose of the Revenue Act is relatively simple. The statute as construed by the courts requires that the consideration received for a transfer of properties represent such an interest in the new enterprise as to preclude the conclusion that there has been a practical severance from the original investment. A parent and a subsidiary clearly represent an economic unit — a conclusion which in no way infringes on the concept of the separate corporate entity for purposes of legal status. Following a transfer of properties to a subsidiary, the interest represented by stock in the parent while indirect, is nonetheless a continuing investment in the welfare of the properties held in the subsidiary. Certainly there has been no sale or liquidation of such properties; rather the value of the parent's stock will depend at least to some extent on the fortunes of the subsidiary which holds the assets. The *Groman* rule ignores the fact of the economic interest provided by the parent's stock and appears to require the receipt of a legal interest.[40]

39. While the term "party to a reorganization" bears a connotation of requiring only a managerial participation in an existing reorganization, a more proper interpretation seems to be that to be a party the corporation must itself be reorganized. The corporation which was reorganized in the *Groman* case was Ohio, as it received the properties and returned stock bearing a continuing interest in the properties. Glidden, having done neither, was not reorganized, and was, therefore, not a "party to a reorganization." In determining whether a corporation has been reorganized, it seems proper to determine whether the consideration received from it represents a continuing interest.

40. Whatever may be said for the *Groman* rule, it is firmly established in the law of tax reorganization. Helvering v. Bashford, 302 U. S. 454 (1938); Neidich v. Comm'r, 105 F. (2d) 1019 (C. C. A. 3d, 1939); United Light & Power Co. v. Comm'r, 105 F. (2d) 866 (C. C. A. 7th, 1939); Whitney Corp. v. Comm'r, 105 F. (2d) 439 (C. C. A. 8th, 1939); Hedden v. Comm'r, 105 F. (2d) 311 (C. C. A. 3d, 1939); Comm'r v. First Nat. Bank of Altoona, 104 F. (2d) 865 (C. C. A. 3d, 1939); Davis v. United States, 26 F. Supp. 1007 (Ct. Cl. 1939); Annheuser Busch, 40 B. T. A. No. 170 (1939); Michigan Steel Corp., 38 B. T. A. 435 (1938); A. W. Mellon, 36 B. T. A. 977 (1937).

The sole case indicating a departure from the *Groman* case is Schuh Trading Co. v. Comm'r, 95 F. (2d) 404 (C. C. A. 7th, 1938). An attempt is made to distinguish the *Groman* principle on the grounds that while the assets were transferred to a subsidiary in return for stock of the parent, the parent was the real recipient, and the subsidiary a mere nominee. Such a doctrine could nullify the *Groman* rule, but it has not been accepted. In the same circuit, in fact, in United Light & Power Co. v. Comm'r, 105 F. (2d) 866 (C. C. A. 7th, 1939) the court based its decision on the authority of the *Groman* case without mention of its earlier holding in the *Schuh* case. The *Schuh* case can be said to carry practically no weight as authority. See Whitney Corp. v. Comm'r, 105 F. (2d) 439 (C. C. A. 8th, 1939).

It is difficult to conceive of any basis in policy for the rule other than a suspicion that the parent-subsidiary relationship is a source of tax avoidance; it is easy to see, on the other hand, that the rule appears in contravention of the policy to exempt from the recognition of gain or loss transactions in which there has been no practical severance from the original investment, but only a change in the form of the interest held.[41]

The parent-subsidiary problem is further complicated by the fact that in some instances courts hold that they will disregard the separate steps in a transaction, which in themselves fall within the statutory requirements, and view the transaction as a whole for tax purposes.[42] This technique is exemplified by the case of *United Light and Power Company v. Commissioner*,[43] where the two separate steps in the transaction each constituted a reorganization, but the transaction taken as a whole was held to fall within the principle of the *Groman* case, and hence taxable income recognized. Here Railways transferred part of its assets to Dexter, receiving all the stock of Dexter in return. This effectuated a reorganization under Part (B) of the definition, since it was a transfer of part of the assets of a corporation to another corporation in exchange for control of the transferee.[44] Then, pursuant to the original contract, Railways transferred all the Dexter stock to American in return for a majority of American stock. This transaction was also a reorganization under Part (A), since it was an acquisition by American of all the stock of a corporation (Dexter) in return for a consideration bearing a continuity of interest (stock of American). The net result, however, was that American was now the parent of Dexter which held the assets transferred by Railways to Dexter, and the consideration finally held by

41. Part (B) of the definition of reorganization in effect since 1934 appears to require an interpretation in accordance with the *Groman* rule, as it requires an acquisition of stock or assets by a corporation solely for all or a part of *its* voting stock. INT. REV. CODE § 112(g)(1) (1939).

42. The so-called single transaction rule is itself one of the more complicated aspects of tax reorganization. A common factual situation raising the issue of its application is a release of control by the transferor in a Part (B) reorganization under the Acts prior to 1934. If the control is found transitory and without real substance, the temporary retention of control will not be respected for purposes of finding a reorganization. See United Light & Power Co. v. Comm'r, 105 F. (2d) 866 (C. C. A. 7th, 1939); Case v. Comm'r, 103 F. (2d) 283 (C. C. A. 9th, 1939); Weicker v. Howbert, 103 F. (2d) 105 (C. C. A. 10th, 1939); West Texas Refining & Development Co. v. Comm'r, 68 F. (2d) 77 (C. C. A. 10th, 1933).

In the case of two related transfers of properties in which for one transfer cash was received, and for the other, stock, there is a tendency to treat the two transfers as one and tax the total gains under the boot provision to the extent of the cash received. See United States v. Rodgers, 94 F. (2d) 666 (C. C. A. 3d, 1938); First Seattle Dexter Horton Nat. Bank v. Comm'r, 77 F. (2d) 45 (C. C. A. 9th, 1935); Henry Hudson, 39 B. T. A. 1075 (1939). For a general discussion of the single transaction principle, see PAUL, SELECTED STUDIES IN FEDERAL TAXATION (1938).

43. 105 F. (2d) 866 (C. C. A. 7th, 1939), *cert. denied*, 60 Sup. Ct. 114 (U. S. 1939).

44. See definition *supra* note 9.

Railways was stock of American. Viewing the transaction as a whole, Dexter, a subsidiary of American, had received from Railways part of the latter's assets and the consideration held by Railways was American stock. This was not a reorganization, as under Part (B) of the definition, the transferor of only part of its assets must receive control of the transferee corporation. This control was vested in American; and even apart from the question of control, stock of American did not represent, under the *Groman* case, a continuing interest in the assets held in its subsidiary, Dexter.

Such a finding of no reorganization could be made only by applying the single transaction principle, the essence of which appears to be that when the separate steps and the final result of the transactions follow from a pre-existing plan, the temporary steps in the attainment of the final result will be ignored for tax purposes and the transaction viewed as a whole.[45] The argument was made and rejected in the *United Light and Power* case that only when the final result is in the nature of a sale should the component steps be disregarded. In the light of the general policy of the statute to protect continuing investments and to tax sales, this argument merits consideration in future litigation involving the applicability of the single transaction rule.

The parent-subsidiary cases, whatever criticism may be made of the reasoning they adopt, at least attempt to apply the continuity rule in its original sense of requiring an interest in the transferee. In one class of case, however, the effort has apparently been made to stretch the rule beyond these limits. In the receivership cases, bondholders purchased the assets of the old corporation at a foreclosure sale and transferred these assets to a new corporation in return for stock in the new corporation. It was contended that the rule of continuity was not satisfied because bondholders were not holders of a continuing interest in the original corporation. This reasoning, sustained by the Board of Tax Appeals,[46] has been rejected in the circuit courts of appeals.[47] It is not altogether clear, however, whether the finding of a reorganization in these cases depended on a rejection of the effort to apply the rule to the original interest held by the bondholders, or on a belief that the bondholders had held a continuing interest in the corporation whose properties were sold on foreclosure. The continuity rule, it is believed, is properly

45. See note 42 *supra*. For a detailed analysis of the *United Light & Power* case and the application of the single transaction rule, see Comment (1939) 34 ILL. L. REV. 303.

46. Irene O. Kitselman, 33 B. T. A. 494 (1935).

47. Comm'r v. Kitselman, 89 F. (2d) 458 (C. C. A. 7th, 1937), *cert. denied*, 302 U. S. 709 (1937); Rex Mfg. Co. v. Comm'r, 102 F. (2d) 325 (C. C. A. 7th, 1939); Comm'r v. Newberry Co., 94 F. (2d) 447 (C. C. A. 6th, 1938). See also Frederick L. Leckie, 37 B. T. A. 252 (1939).

It is doubtful whether under Part (A) of the definition of reorganization, effective since 1934, a proceeding under § 77B or Chapter X of the Bankruptcy Act will be deemed a "statutory merger or consolidation." See letter of Acting Deputy Commissioner, 383 C. C. H. 1938 Fed. Tax Serv. ¶ 6044.

applicable only to the interest retained in the transferee at the completion of the transaction — that is, in the consideration received — and the nature of the original investment should be irrelevant in determining the character of the transaction which purports to be a reorganization.

This discussion of the rule of continuity has concerned itself with the definition of reorganization as it existed prior to the 1934 Act. For the old parenthetical clause, the newer definitions have substituted a Part (B) reorganization which requires a receipt of a consideration solely in voting stock.[48] The older Acts, however, are far from outdated for purposes of interpretation by the courts. Not only is this true because of the slowness of tax litigation, but in addition, the basis provisions give a virtually unlimited life to the older Acts, for on a subsequent liquidation of property received pursuant to a tax free exchange, the basis for such property is the same as the basis of the property transferred by the taxpayer.[49] Therefore, many exchanges made prior to 1934 will have to be examined in the light of the old statutes to determine whether or not they gave rise to gain or loss.

Further, the concept of continuity is not necessarily absent in the newer Acts in spite of the new Part (B) definition. Part (A) requires "statutory merger or consolidation," and several states allow a receipt of securities other than stock,[50] thereby raising a possible application of the *LeTulle* case. While it seems proper to interpret the statute as leaving the requisites of merger or consolidation to the standards set by state statutes, it can not be assumed that the judicial rules as to the consideration which must be received will be abandoned. Finally, apart from the reorganization definition, the distinction between "stock or securities" and "other property" still remains in the boot provisions,[51] and some continuity concept will continue to constitute the dividing line. Thus several situations remain in which the rule of continuity of interest can be applied; and the rule is too useful an argumentative device to be forgotten merely because the issue in the *Pinellas* and *Cortland* cases has been covered by the newer statutes.

48. See note 11 *supra*.

49. INT. REV. CODE § 113(a)(6) (1939).

50. See, for example, ARK. DIG. STAT. (Pope, 1937) § 2223; CAL. CIV. CODE (1937) § 361; FLA. COMP. GEN. LAW (1927) § 6562; NEV. COMP. LAWS (Hillyer, 1929) § 1638; OHIO CODE ANN. (Baldwin, 1936) § 8623-67; TENN. CODE (Williams, 1934) § 3750; ILL. REV. STAT. (1939) c. 32 § 157.62. See also Fahey, *Income Tax Definition of Reorganization* (1939) 39 COL. L. REV. 933, 950.

51. INT. REV. CODE § 112(c)(1) (1939).